

What's going on in Latam? The same old Samba for rates...

Brazil has been doing its thing as of late, and it's not been a happy samba. Here, we ask what's next. We contrast Brazil with Mexico and the US, employing mean-reversion as our guide. We also bring Colombia and Chile into the conversation. Bottom line, Brazil still needs to hike. Mexico and Colombia can comfortably cut. Chile can too, but not comfortably



The Central Bank of Brazil, Brasília

Banco Central do Brasil likely has to hike by another 175bp, and then we'll see

We noted some months back that Brazil had run out of a “comfort buffer”. See an example [here](#). Its central bank's rate differential to the US had fallen to 5%. That sounds high. But 5% is some 3.5% below the average of the past decade and a half. That can be fine if fundamentals are fine, but they've clearly not been. Since then, Banco Central do Brasil (BCB) has hiked by 175bp, partly to mute a collapsing real. So, where now?

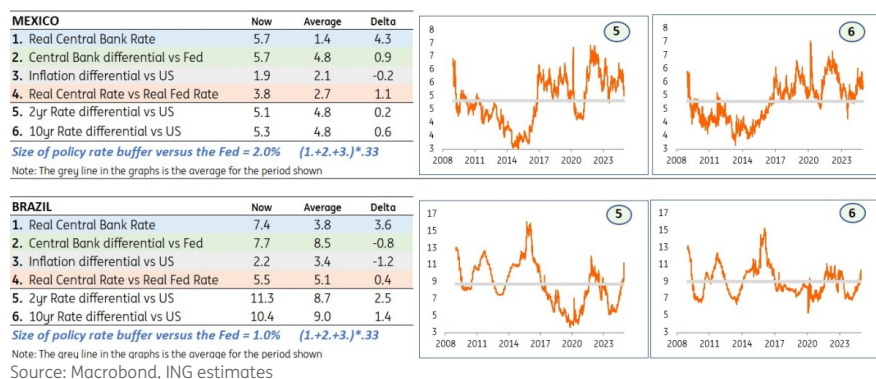
First some context. Both Mexico and Colombia have a near 1% positive buffer in terms of their respective average central bank policy rate differentials versus the Federal Reserve. In contrast,

Brazil has a near 1% negative buffer on this measure. Ideally, it will need to close this up to zero, and likely will need to generate a positive buffer, probably in the region of 1%. That equates to another 175bp in rate hikes, based on this metric alone.

That would in fact likely prove to be an overshoot to the upside, as other metrics are far more comfortable. The domestic real rate differential is at 7.4%, some 3.6% above the historical average. More rate hikes would directly add to this, helping to contain inflation risks now being amplified by peso weakness, but with a significant risk of harm to the economy. There will be subsequent talk of rate cuts should such extreme easing need to be delivered.

Market rates are already trading at quite concessional levels, currently at comfortable double-digit spreads versus the US. Versus historical averages, there's now a cushion of 2.5% in the 2yr and 1.4% in the 10yr. Likely there is still pressure for these spreads to widen some more, but at the same time quite some concession has already been priced. These positive deltas in the 2yr and 10yr versus the US contrast with a negative delta of -0.8% on the policy rate. It's the latter that requires adjusting higher.

Key differentials versus the US for Brazil and Mexico and the rate buffer calculation



There is similar gap between Brazil and Mexico, which can be closed from both sides

We see something similar when we contrast Brazil with Mexico. The 2yr spread to Mexico is at 6.2%, which is some 2.3% above average, and the equivalent delta in the 10yr is 0.8%. In contrast there is a negative delta in the policy rate differential versus average. Currently, the BCP rate is 2% above Banxico's. The historical average is 3.7%. That's a negative delta of -170bp. The BCP needs to hike (and/or Banxico to cut) in order to close that. And that only gets us back to a type of neutrality, which implies that more likely still needs to be done should macro pressures (and FX) persist in Brazil.

As for Mexico, at the moment, Banxico has a 2% buffer based off a combination of the nominal rate differential vs US (table above), the real rate differential vs US and the domestic real rate. If we look at just the nominal and real rate differentials vs US, there is a 1% buffer. Either way, Banxico has room to move back towards long term averages, and at the very least it can therefore match the Fed and cut by 25bp. It has room for more if it so chooses.

Brazil versus Mexico - key spreads

| Brazil vs Mexico | Now | Average | Delta |
|----------------------------------|------|---------|-------|
| 1. Policy Rate differential | 2.0 | 3.7 | -1.7 |
| 2. Real Policy Rate differential | 1.7 | 2.4 | -0.7 |
| 3. Inflation differential | 0.3 | 1.3 | -1.0 |
| 4. FX rate (x BRL per 1 MXN) | 0.30 | 0.20 | 51% |
| 5. 2yr Rate differential | 6.2 | 3.9 | 2.3 |
| 6. 10yr Rate differential | 5.0 | 4.2 | 0.8 |

Source: Macrobond, ING estimates

The respective pressures opens opportunity in relative rates

A notable difference between Brazil and Mexico is the performance of respective currencies. Yes, the Mexican peso has had a weakening tendency since the election outcome that coalesced on the judicial reform issue. But that merely took the peso away from a very rich valuation towards a more neutral one. In contrast, the Brazilian real has gone a tad off the rails, and has shot into material weakness territory versus fair value. The messaging there is poor for Brazil in relative terms. This is not a huge surprise to us. Mexico is far from a perfect story, but relative to Brazil, it looked like a much better one. See more [here](#) and [here](#).

At some point, Brazil will begin to offer value and we'll go the other way on this trade. That likely requires another round of big BCB rate cuts first, while delivery of a couple of Banxico rate cuts can build that concession from the other side. Watch this space. The 2yr spread is now 6.2% and the 10yr is at 5%. Entry points at 7.5% and 6% respectively would be more than enough concession. Even 50bp off these are worth a look. We don't necessarily have to get to the extremes for the policy rate as currently discounted before getting back in.

Colombia is in the same camp as Mexico, but Chile has less room for manoeuvre

Separately, we note that the market is discounting a 25bp cut from Banco Central de Chile (BCC) and a 50bp cut from Banco de la República de Colombia (BanRep). Our analysis identifies a vulnerability to the BCC move, as we have a negative buffer in play, which can pose FX risks if pushed too far. It's been in the "dodgy zone" for some time. See more [here](#). In contrast, for BanRep we identify a positive buffer of 1.7%, signalling room to cut, and there's therefore no issue with the cutting agenda there. See our previous note on that [here](#).

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group*

(being for this purpose ING Group N.V. and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.